

**Testimony of
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**Committee on Ways and Means
Subcommittee on Oversight
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**Hearing on
Tax Related Provisions in the President's Health Care Law
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Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee, thank you for the opportunity to testify on the tax related provisions in the Health Care and Education Reconciliation Act of 2010 and Patient Protection and Affordable Care Act (jointly referred to as the "ACA").

My name is David Kautter and I am the Managing Director of the Kogod Tax Center. The Kogod Tax Center is a tax research institute located at American University's Kogod School of Business that promotes balanced, nonpartisan research on tax matters, including the challenges of complying with the Internal Revenue Code. Our efforts focus principally on tax matters affecting middle-income taxpayers, small businesses and entrepreneurs. We also develop and analyze potential solutions to tax-related problems faced by these three groups of taxpayers and promote public dialogue about critical tax issues.

I have been a tax practitioner for over 40 years. Prior to joining the Kogod Tax Center, I was the Director of National Tax for Ernst & Young. Over the course of my career as a tax practitioner, I have watched the tax law grow increasingly complex in its structure, pervasive in its reach and incomprehensible in its nature. There is little doubt that the nearly paralyzing complexity, overwhelming length and constantly changing nature of our federal tax laws are having a profound effect on economic decision making and impeding our global competitiveness.

It is estimated that the Internal Revenue Code is nearly four million words in length, and the income tax regulations are in excess of another 5 million words. Taxpayers are estimated to spend more than 6.1 billion hours meeting their annual federal tax filing obligations, and it is also estimated that 60% of all taxpayers retain paid tax return preparers to fulfill their federal tax filing obligations while another 30% use commercial

software. Complexity has been identified by the IRS Taxpayer Advocate in her most recent report to Congress “as the #1 most serious problem facing taxpayers.” I can personally attest that the effort required to comply with the tax law today is disheartening even to experienced tax professionals. The cost to comply is increasingly expensive in time and dollars. Not only that, the excessive burden of compliance is increasingly distorting individual and business decision making.

Patient Protection and Affordable Care Act

The ACA contains over 45 different tax or tax-related provisions. I would like to focus my testimony today on two of the more significant provisions in the ACA in terms of revenue and reach: (1) the new 0.9% Medicare tax on wages, and (2) the 3.8% tax on net investment income (NII). The statute, proposed regulations and preambles for these two provisions are over 48,000 words and take up over 85 pages in the Federal Register. The estimated total annual reporting and recordkeeping burden for the new Medicare tax on wages alone is estimated to be 1.9 million hours. And that is for the more straightforward of the two taxes I will discuss today.

Net Investment Income Tax

The ACA adds a third tax system to the Internal Revenue Code, the “Net Investment Income Tax.” This system sits alongside, and parallels, the regular income tax and the Alternative Minimum Tax (AMT) as a self-contained tax system within the Internal Revenue Code. Like the regular tax and the AMT, this new tax system comes complete with its own set of definitions, its own unique rules for computing amounts subject to the tax, its own unique rules for allocating deductions to various types of income, its own unique rules for determining which taxes are creditable against the new tax and its own special rules. The threshold for the tax, like the previous threshold for the AMT, is not indexed for inflation. This new tax system, which is its own parallel universe, also comes complete with its own compliance obligations, additional tax forms, tax calculations and requirement to pay estimated taxes. The Net Investment Income Tax appears in a new, separate Chapter of the Internal Revenue Code; this in and of itself is a matter of complexity. Except for some limited cross-references to other provisions in the Internal Revenue Code, this new Chapter does not provide definitions of its operative phrases or terminology. That is left to the IRS and the courts to develop which, again, brings its own level of complexity. The Net Investment Income Tax, like the additional tax on Medicare wages, imposes a new calculation not previously required of taxpayers. This calculation is simply added on top of an already exceedingly complex federal income tax law.

Although the Net Investment Income Tax is thought of as an increase in the rate of tax on capital gains and dividends, it is much more than that. The tax on Net Investment Income (NII) extends to a wide range of

income well beyond capital gains and dividends. Income from: (1) interest, annuities, royalties and rents other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (2) income from a trade or business that is a passive activity, (3) net gains from the disposition of property that is not held in a trade or business, (4) income attributable to investment in working capital, and (5) any income derived from trading in financial instruments and commodities are all subject to the new tax.

The rate of tax is 3.8% of the lesser of: (1) an individual's net investment income for a taxable year; or (2) the excess of (a) the individual's modified adjusted gross income over, (b) the threshold amount of \$200,000 for single taxpayers, \$250,000 for married taxpayers and \$12,950 for estates and trusts. Modified adjusted gross income is fairly straightforward but the definition of Net Investment Income is more complicated. Listed below are some illustrations of areas where taxpayers will encounter substantial complexity in trying to live up to their legal obligations

Areas of Complexity in the Determination of Net Investment Income

Although this new Chapter of the Internal Revenue Code does not provide definitions of its operative phrases or terminology, proposed regulations issued by the IRS provide that many existing rules that apply for purposes of determining taxable income under the general provisions of the Internal Revenue Code will often apply for purposes of computing the tax on NII. This approach substantially simplifies what could otherwise be a complicated and duplicate set of rules that would not only be unnecessary but expensive and burdensome. This is not to say that computation of NII will be simple or non-controversial since the definitions being used are the very ones that make the existing law so complicated and incomprehensible to most taxpayers.

- **Allocation of expenses**

In computing NII, taxpayers are allowed to allocate certain deductions to their NII. In the case of itemized deductions, only the amount allowed after reducing the deductions for the 3% disallowance can be allocated. If the deduction is a miscellaneous itemized deduction, then the 2% reduction must be taken into account before the 3% reduction is computed. This will not be an easy calculation to make in some cases.

- **Treatment of Investment Income from Pass-through Entities**

Another challenge in determining NII is the requirement that investment income received by a partnership, S corporation, or limited liability company is included in the calculation of investment income of their owners. Specifically, §1411(c) adopts the passive activity rules of §469 to determine if income attributable to an individual from a pass-through entity is investment income. One of the most

complicated and controversial areas of the existing Internal Revenue Code is the passive loss rules. If the partnership, S corporation or limited liability company is not engaged in a trade or business then the individual's distributive share of the entity's income constitutes investment income. If, on the other hand, the entity is engaged in a trade or business, the entity's income attributable to an individual owner is investment income only if the activity is passive under §469 with respect to that owner. Aside from the computational challenges this rule creates, there is the difficulty in determining the entity's investment income attributable to an owner when a partnership, limited liability company or S corporation is actively engaged in a trade or business but the owner of the entity is not so engaged.

- **Disposition of Interests in Pass-Through Entities**

In the case of a disposition of an interest in a partnership or S corporation, gain or loss from the disposition is treated as investment income or loss to the extent the gain or loss is attributable to the transferor's interest in each asset, the sale of which by the partnership or S corporation would give rise to investment income or loss. Any adjustment of the gain or loss from the sale of a partnership interest or S corporation stock that is not investment income or loss must be reported and explained on a statement attached to the seller's return for the year of the disposition. Finally, income from a lower tier pass-through entity owned in part by an upper tier pass-through entity creates tracing problems for identifying the upper tier owner's share of the lower tier entity's investment income

The areas of greatest complexity and likely dispute between taxpayers and the IRS with respect to the tax on Net Investment Income are likely to center on the application of the rules to passive activities and the application of the rules to partnerships and S Corporations, especially multi-tiered ownership arrangements.

Changing Behavior

From a tax planning point of view, when it comes to the tax on NII, taxpayers will be focused on simultaneously managing two entirely new calculations: (1) Modified Adjusted Gross Income, i.e., "threshold planning" and (2) Net Investment Income. For example, if a taxpayer will likely be under the threshold in a particular year, planning will focus on increasing NII to utilize the full amount of the threshold. If a taxpayer will likely be over the threshold, planning will focus on minimizing NII for that year. This focus will be integrated with tax planning that taxpayers will be doing with respect to the regular income tax, AMT, and the additional tax on Medicare wages. Make no mistake about it, planning to minimize and comply with the tax on NII will consume tens of thousands, if not hundreds of thousands, of hours of time of taxpayers and their advisors over the next

year and every year thereafter. This will be in addition to the 6.1 billion hours currently being spent on complying with the rest of the Internal Revenue Code.

Here are some of the types of changes in behavior that we can expect to see.

- Investments in municipal bonds and whole life insurance policies that not only do not count in modified adjusted gross income (MAGI) but do not count as NII will become very attractive. Investments that defer inclusion in MAGI for extended periods of time such as growth stocks and annuities will likely be used more extensively.
- Capital gain planning will take on greater importance. While this clearly goes on today it will take on more importance. Timing the recognition of capital gains will allow taxpayers to control both their MAGI and the NII, and matching capital gains with capital losses will also take on greater importance.
- Use of the installment method of accounting. This will allow taxpayers to avoid large spikes in MAGI in the year of sale and also allow taxpayers to better control the amount of NII realized each year thereafter.
- Like-kind exchanges. Use of the like-kind exchange rules will become more popular since they can result in deferring increases in MAGI and deferring the receipt of NII.
- Retirement planning. Distributions from retirement vehicles such as qualified retirement plans and IRAs are excluded from the definition of NII and will become more attractive. In addition, Employers such as sole proprietors, S Corporations and partnerships may be inclined to contribute more to qualified plans in particular years to reduce MAGI in the year of contribution and receive distributions in a manner designed to minimize MAGI and reduce the amount of NII subject to tax in a later year.
- Roth IRAs and Roth 401ks. Even though contributions to Roth IRAs and Roth 401ks do not reduce MAGI in the year of contribution, distributions do not increase MAGI in the year of distribution nor are they NII.
- Gifts of appreciated property. Gifts of appreciated property will allow taxpayers to transfer MAGI and NII to donees. The “kiddie tax” rules will limit the ability to use this technique in some situations.
- Trusts. Trusts will have an incentive to distribute income to individual beneficiaries who have a higher MAGI threshold.
- Charitable Remainder Trusts. Contributions to CRTs will allow taxpayers to shelter NII while smoothing MAGI over a lengthy period of time. CRTs can also sell appreciated property without paying tax which

allows beneficiaries to, in effect, diversify assets without increasing MAGI at the time of sale and deferring NII.

- Passive activities. Passive income increases MAGI and is NII so taxpayers will benefit if they can generate passive losses to offset against the passive income.

Additional Medicare Tax on Wages (AMTW)

Under the ACA, an additional 0.9% tax is imposed on wages and self-employment income in excess of \$200,000 for single taxpayers, \$250,000 for married taxpayers and \$125,000 for married taxpayers filing separate returns.

The 0.9% AMTW introduces new complexity in the tax law in three ways: (1) it is the first time that Medicare tax is computed on an individual's personal income tax return; (2) it is the first time that the Medicare tax is imposed solely on employees without a matching employer payment; and (3) it is the first time that the amount of Medicare tax varies with a taxpayer's marital status. These are by no means trivial changes. They bring with them new rules for withholding, computing and paying Medicare tax, as well as plenty of opportunities for mistakes and penalties. They affect employees, employers and self-employed individuals. Described below are some illustrations of this increased complexity.

Potential Underpayment Penalties

All taxpayers are required to pay at least 90% of the tax they will owe for a taxable year either through estimated tax or direct withholding, or else face penalties. For employees, this requirement is usually met by having amounts withheld from their wages. For purposes of the AMTW, no Medicare tax can be withheld on an employee's wages less than \$200,000. Even if the employee knows that they will owe the AMTW (because of wages from another job or a spouse's wages) and the employee requests additional AMTW withholding, the employer is not allowed to withhold AMTW if the employee's wages are less than \$200,000. Instead, the employee must request that additional income tax be withheld by filing a Form W-4 with their employer. The employee can then claim the additional income tax withheld as a credit against their AMTW when he or she files their tax return. In my experience, one of the most misunderstood and improperly completed forms is the Form W-4. Having to request additional income tax withholding in order to satisfy a Medicare tax liability is a novel concept in the tax law and one which adds a complexity to what was previously a straightforward computation. The alternative available to an employee is to pay the AMTW liability by making estimated tax payments. For someone who has been an employee all his or her life, entry into the world of estimated tax payments is usually not a pleasant one. Figuring out how to make quarterly estimated tax payments,

computing them and paying them timely is not easy or intuitive. No matter which way an employee in this situation turns, she is faced with a new and complicated decision and the price for a mistake is penalties.

Potential overpayment of AMTW

A second area of complexity for employees involves married employees who earn wages in excess of \$200,000. If a married employee makes more than \$200,000, AMTW must be withheld even though the employee and his or her employer may know that no AMTW will be owed because the combined wages of the employee and the employee's spouse on a joint return will be less than \$250,000. It is clear that in this case the employee must wait until he or she files an income tax return to claim a refund for the excess AMTW that has been withheld.

Combined Wages

Another area of complexity involves the imposition of the AMTW on the combined wages of spouses who file a joint return. This departs from the rules that have existed since the enactment of Medicare and will be a source of confusion for many taxpayers.

Employee Burden if an Employer Fails to Withhold

If an employer fails to withhold the appropriate amount of AMTW, the employee will be responsible for paying the proper amount of tax either through estimated tax payments or as an addition to tax on her income tax return. Again, this is novel with respect to Medicare tax and will be a source of confusion for taxpayers, as well as a potential source of penalties.

The Problem with Thresholds

One of the complicating aspects of these new rules is that the AMTW is imposed only on wages (or combined wages in cases where taxpayers are married and file a joint return) in excess of a threshold amount (\$200,000 for single taxpayers and \$250,000 for married couples).

It is not uncommon for taxpayers to have fluctuations in their wages from year to year as a result of bonuses, stock option exercises, vesting in restricted stock or deferred compensation or other non-recurring events. In these situations, taxpayers may find themselves over the threshold in one year and subject to a substantial AMTW liability even though, had they received the income pro-rata over the period the payment was earned no tax would be due. Moreover, because the threshold amount for a married couple is 75% less than the combined threshold for two single taxpayers, the threshold penalizes couples who are married and filing joint returns.

Self-Employed Taxpayers

Another source of complexity is that self employed taxpayers must now take the AMTW into account in making their estimated tax payments. However, unlike the base 2.9% Medicare tax, the AMTW is not deductible for regular tax purposes. So, in computing the amount of estimated income tax to be paid, self-employed individuals will have to take part of their Medicare tax into account and ignore the rest. This is counter-intuitive and a potential trap for the unwary. In addition, if a self-employed individual also has wages, like many small business owners do, the interaction of the AMTW on wages and the AMTW on self employed income can become quite complicated.

Employer Burdens

The AMTW also creates a series of new rules and resulting complexity for employers. While large employers are better able to deal with this complexity, small businesses will find themselves with another set of rules that may be costly and confusing. Here are the primary additional burdens placed on employers by the AMTW: (1) employers must withhold the AMTW on wages in excess of \$200,000; (2) employers must file a return reporting the additional AMTW; (3) employers must follow very specific rules with respect to correcting underpayments and overpayments of the AMTW; (4) employers must follow very specific rules with respect to claiming refunds; and (5) penalties or additions to tax for failure to withhold the AMTW are imposed even if the employee pays the AMTW that is owed. While many of the rules that must be followed are the same as the existing rules for the base Medicare tax, having to account for one more employment tax will surely increase the likelihood of error and the likelihood of penalties.

S Corporations

Amounts paid as wages to S Corporation shareholders are subject to AMTW, but amounts distributed as earnings to the same shareholder are not. An area of increasing controversy and one that frequently reaches the courts is how much of the earnings of an S corporation a shareholder should consider wages (and thus subject to employment taxes) and how much should be treated as distributions of earnings (and not subject to employment tax). The additional 0.9% tax is likely to increase the number of disputes in this area, absorbing increasing amounts of time on the part of the IRS and small business owners.

Changing Behavior

It is already clear that employee-taxpayers and their employers are seeking to alter behavior in order to both minimize the new 0.9% tax on employees and the burden on their employers. Here are some of the areas being discussed by taxpayers and their advisers to minimize the effect of this new tax.

Because employer contributions to qualified pension plans are not subject to AMTW when they are made and distributions from qualified plans are not subject to AMTW when received, discussions are under way as to whether less compensation should be paid in cash and more contributed to qualified plans. There are limits as to how much can be contributed to qualified plans, both dollar limits and discrimination limits, but within those limits substantial discretion exists.

The tax and the employer burden can both be reduced by converting what are currently wages into tax-free fringe benefits, such as more generous health benefits, employee financial planning or employer paid parking. This not only reduces the AMTW but reduces wages subject to income tax as well as wages subject to basic FICA tax. So, to the extent taxpayers convert what were previously taxable wages into tax free-fringe benefits, not only is the 0.9% tax avoided, but income taxes and basic FICA taxes (employer and employee shares) that were previously paid will no longer be paid.

Because wages paid to an S corporation shareholder are subject to the 0.9% tax, but distributed earnings are not, some taxpayers are considering whether to conduct business as an S Corporation and paying the minimum amount of wages possible. Although this issue already exists, the addition of the 0.9% tax will add another reason to change the form of a small business to an S corporation and then minimize the amount paid to the shareholder-employee as wages, while maximizing the amount paid as earnings.

As an alternative to conducting business as an S corporation, taxpayers are considering limited partnerships because earnings paid to limited partners are not subject to the AMTW.

Also under discussion is whether employees should recognize wage income and pay the AMTW earlier in the hopes of minimizing what would have been a larger AMTW liability later. For example, exercising of stock options earlier than they might otherwise be exercised and making elections under IRC Section 83(b) on restricted stock would accelerate the payment of the .9% tax but result in an overall lower payment of income tax, base FICA taxes and the .9% tax.

Unfairness of Thresholds

A taxpayer's income can increase substantially in one year due to a once in a lifetime event, such as the sale of a home or other long held capital asset. In situations such as these, taxpayers are taxed at extraordinarily high

rates even though the gain accrued over a lengthy period of time and may never recur in the taxpayer's lifetime. The unfairness of taxing such one-time gains at higher rates will contribute to a perception of unfairness and possibly increase cynicism on the part of taxpayers.

Three New Thresholds in One Year

The ACA introduces a new threshold of \$200,000/\$250,000 over which the AMTW and the tax on NII is imposed. In addition, the PEP and Pease provisions come back into effect in 2013 for taxpayers who have AGI in excess of \$250,000/\$300,000. Third, there is a new threshold for the top individual rate of tax of 39.6% which is \$450,000/\$400,000. The imposition of three new thresholds in one taxable year substantially increases the complexity of complying with the federal tax law. With three new thresholds, the complexity is not arithmetically increased by a factor of three; it is increased exponentially because all three thresholds interact with each other.

Thank you for allowing me to testify today. I would be delighted to address any questions from any Member of the Committee or your staff today. I and others at the Kogod Tax Center would be pleased to address any further questions with you at any future date, as well.